

**Testimony Before the Subcommittee on Financial Services  
and General Government  
Committee on Appropriations  
United States Senate**

**by**

**Chairman Mary L. Schapiro  
U.S. Securities and Exchange Commission**

**June 2, 2009**

Chairman Durbin, Ranking Member Collins, Members of the Subcommittee:

Thank you for the opportunity to testify today. I sincerely appreciate the support this Subcommittee has shown the Securities and Exchange Commission, and I am pleased to have the opportunity to discuss with you the Commission's role in helping to address the financial crisis, and to discuss reforms to improve investor protection and restore confidence in our markets.

The last year has been a wrenching time for the investors whom the SEC is charged with protecting. Trillions of dollars in wealth have been destroyed during the economic downturn, and millions of Americans have seen their retirement nest eggs and college tuition funds shrink dramatically as a result. The economic crisis has challenged faith in our system of capital formation and allocation – a system that has proved over the long term to be the greatest for creating wealth the world has seen.

As an agency charged with protecting investors, maintaining fair, orderly and efficient markets, and facilitating capital formation, we are dedicated to understanding and learning from recent events and from the causes that were building in the system over the years, so that we can do our part to restore market integrity and investor confidence. The SEC must act promptly, decisively, and with resolve. We also must have a renewed commitment to protecting investors; they provide the capital used to fund the productive enterprises that create jobs and wealth. While we have a tripartite mission at the SEC, investor protection is the foundation upon which all our responsibilities are built.

To that end, I've already announced several changes at the agency that will reinforce our focus on investor protection and market integrity and redirect our energies toward restoring investor confidence.

## **Reinvigorating SEC Enforcement**

One of my very first actions as Chairman was to end the two-year “penalty pilot” program, which had required the Enforcement staff to obtain a special set of approvals from the Commission in cases where the staff sought fines against public companies that violated the law. Some enforcement staff had complained that the procedures unnecessarily delayed the prosecution of cases, and discouraged the staff from either seeking a penalty or seeking an appropriately high penalty. At a time when the SEC needs to send a clear message that corporate wrongdoing will not be tolerated, and penalties for securities violations will be stiff, the penalty pilot program was an unnecessary hurdle to more active enforcement.

Another change I implemented to bolster the SEC’s Enforcement program was to provide for more rapid approval of formal orders of investigation, which allow SEC staff to use the power of subpoenas to compel witness testimony and the production of documents. In investigations that require the use of subpoena power, time is of the essence; delay can be costly to an investigation. To ensure that subpoena power is available to the staff when needed, the agency has returned to a policy of timely consideration of formal orders by the seriatim process or, where appropriate, by a single Commissioner acting as duty officer.

In addition, I have hired a new enforcement director, a longtime federal prosecutor who served as Chief of the Southern District of New York’s Securities and Commodities Fraud Task Force, charged with focusing our enforcement efforts on bringing meaningful, high impact cases quickly. We are working together on management reforms — including harnessing technology, improving risk assessment, and improving training and supervision for our line law enforcement personnel — so that we can maximize our resources to combat fraud and wrongdoing in our markets. Our Division of Enforcement has been working diligently. Since the end of January,

- We have filed at least 34 emergency temporary restraining orders. During roughly the same period last year, we filed 12.
- We have opened more than 358 investigations. During roughly the same period last year, we opened 292.
- The Commission has issued at least 188 formal orders. During roughly the same period last year, the Commission issued 74.

Since January, we have brought a number of important and complex cases. For example, in the Reserve Fund matter filed in May, we charged certain operators of the Reserve Primary Fund, a \$62 billion money market fund whose net asset value fell below \$1.00 or “broke the buck” last fall, with fraud for failing to provide key material facts to investors and trustees about the Fund’s vulnerability as Lehman Brothers Holding, Inc., sought bankruptcy protection. As part of this action, we are seeking to bring about an expedited, efficient, and equitable pro-rata distribution to shareholders of the Fund’s remaining assets, including \$3.5 billion originally set aside in the Fund’s litigation reserve.<sup>1</sup> We believe this will help Reserve Fund investors recover a larger share of their assets.

In March, we initiated a case alleging fraud in connection with a kickback scheme involving New York's largest pension fund. Namely, we charged New York's former Deputy Comptroller and a top political advisor with extracting kickbacks from investment management firms seeking to manage the assets of the New York State Common Retirement Fund. Since March, we have amended the complaint to add additional defendants, including a former New York state political party leader, a former hedge fund manager, a Dallas-based investment management firm and one of its founding principals, and a Los Angeles-based "finder."<sup>2</sup>

As committed as we are to vigorous enforcement of the securities laws, we are also mindful that the complexity of 21<sup>st</sup> century markets, as well as the varied nature of frauds and scams, require that the sophistication and tools available to our Enforcement and Examination programs keep pace. Important questions have been raised concerning the agency's handling of tips or whistleblower information related in particular to the activities of Bernard Madoff. Clearly this is something we must learn from, and I am committed to addressing it. Former Chairman Cox asked the SEC Inspector General to look into what happened, what failed to happen, and to report back to the Commission. We expect to receive the IG report this summer and will promptly take all appropriate actions and address any remaining shortcomings.

It is clear that, regardless of any findings of the Inspector General, the agency must improve its ability to process and pursue appropriately the hundreds of thousands of tips and referrals it receives annually. In February, we retained the Center for Enterprise Modernization which began work immediately on a comprehensive review of internal procedures to evaluate tips, complaints, and referrals. We are in the process of creating a system that will centralize this information so we can track it, analyze it and more effectively identify valuable leads for potential enforcement action and compliance exams.

### **Strengthening Examination & Oversight**

In addition to these changes, it is essential that we work to improve our risk-based oversight of broker-dealers, investment advisers and mutual funds. Our Office of Compliance Inspections and Examinations (OCIE), together with other agency staff in the Office of Risk Assessment, are presently working on an initiative to identify the key data points that would facilitate an improved risk-based oversight methodology to allow the staff to identify and focus on those firms presenting the most risk. OCIE has improved training and, under a newly authorized program, 268 examiners are now participating in the training and certification program offered by the Association of Certified Fraud Examiners, to identify the warning signs and red flags that indicate evidence of fraud and fraud risk. OCIE is also recruiting additional individuals with experience in different facets of the industry, such as trading, risk assessment and compliance. These steps taken together will expand the knowledge base of our inspections staff, better enabling them to conduct oversight of complex trading strategies and products that exist in our markets today.

I have also launched an Industry and Markets Fellows Program in our Office of Risk Assessment. Through this program, we have begun recruiting fellows with extensive experience

in such areas as equity and fixed income securities trading, structured products, complex derivatives, financial analysis and valuation, fund management, investment banking and financial services operations.

### **Improving Transparency & Investor Protection**

The agency is working hard in other areas as well. In the area of accounting standards, the SEC staff completed a congressionally-mandated study of fair value accounting. The staff issued guidance to financial institutions so that they can give fuller disclosure to investors, particularly with respect to hard-to-value assets. The staff has also continued to work closely with the Financial Accounting Standards Board to deal with such issues as consolidation of off-balance sheet liabilities, the application of fair value standards to inactive markets and the accounting treatment of bank support for money market funds. FASB recently took steps to clarify treatment of off-balance sheet items in a manner designed to increase market transparency.

In the area of combating false rumors and manipulative activity in the marketplace, the agency initiated examinations of the effectiveness of broker-dealers' and investment advisers' controls to prevent the spreading of false information. When concluded, the results of these examinations will be used by regulators to assist firms in crafting and implementing robust policies and procedures to prevent the spreading of false information.

In the wake of recent Ponzi schemes and other investment adviser abuses, the Commission last month proposed significant changes to the custody requirements for investment advisers. These proposals focus on the value of an independent public accountant serving as another set of eyes to better assure the safekeeping of investor assets. One proposal would require all advisers with custody or control of client assets to engage an independent public accountant to conduct an annual "surprise exam" to verify those assets exist. A second proposal would apply only to investment advisers whose client assets are not held by a firm independent of the adviser. In such cases, the investment adviser would be required to be subject to a review that results in a written report -- prepared by a PCAOB-registered and inspected accounting firm -- that, among other things, describes the controls in place relating to custodial services, tests the operating effectiveness of those controls and provides the results of those tests. These reports are commonly known as SAS-70 reports. The reports would include an opinion of an independent public accountant issued in accordance with the standards of the PCAOB, which will provide an important level of quality control over the accountants performing this review. In addition, advisers would be required to publicly disclose the name of the accountant conducting these reviews, so that our staff can better monitor compliance and assess adviser compliance risks. Accountants also would be required to disclose the reason for any termination or resignation from performing these reviews, which should highlight any "red flags" for regulators and investors.

At my request, our staff is also developing investor-oriented enhancements to the municipal securities area. It is time for those who buy the municipal securities that are critical to state and local funding initiatives to have access to improved quality, quantity and timeliness of information. On a related note, so called "pay-to-play" practices by investment advisers to

public pension plans must be curtailed. I have asked the staff to revisit the Commission's 1999 proposal to address harmful pay-to-play practices, and I expect that the Commission will consider that proposal this summer.

### **Combating Abusive Short-Selling**

In my brief tenure as Chairman, the issue of short selling has outpaced any other in terms of the number of inquiries, suggestions and expressions of concern we have received. On April 8, 2009, the Commission unanimously voted to propose two distinct approaches to short selling restrictions. One approach would impose a permanent, market-wide short sale price test, while the other would impose temporary short selling restrictions upon individual securities during periods of severe declines in the prices of those securities. On May 5, 2009, the Commission held a public roundtable to solicit the views of investors, issuers, financial services firms, self-regulatory organizations and the academic community on key aspects of these proposals. The Commission is committed to conducting a thoughtful, deliberative process to determine what is in the best interests of investors, including examining a variety of trading and market related practices such as securities lending.

We also recognize that strong rules and vigorous enforcement are needed to curb abusive short selling and restore confidence in our markets. The Commission has been focused on the issue of abusive "naked" short selling since before my arrival in late January, and the Commission's regulatory actions have led to a significant decline in failures to deliver securities on time following a short sale. Moreover, our Division of Enforcement has a number of active investigations involving potentially abusive short selling in a variety of contexts.

### **Filling Regulatory Gaps**

In an effort towards bringing the unregulated world of credit default swaps into the sunlight, the Commission, working in close consultation with the Board of Governors of the Federal Reserve System and the Commodity Futures Trading Commission ("CFTC") and operating under the limitations of the current legislative structure, recently issued temporary orders to facilitate the establishment of central counterparties for clearing credit default swaps ("CDS") by LCH.Clearnet Ltd., ICE US Trust LLC, and Chicago Mercantile Exchange Inc. The Commission is committed to increasing investor protection and reducing systemic risk by facilitating the development and oversight of central counterparties to clear CDS.

We have also been working with the CFTC and Treasury Department to fill regulatory gaps in this area to help increase transparency and minimize risks associated with certain derivative products, including CDS, as well as market participants transacting in these products. I look forward to working with Congress to make the necessary legislative changes to ensure that these markets and market participants are appropriately regulated.

In addition, we are closely examining the broker-dealer and investment adviser regulatory regimes and assessing how they can best be harmonized and improved for the benefit of investors. Many investors do not recognize the differences in standards of conduct applicable to

broker-dealers and investment advisers. It is essential that comparable and effective protections be afforded to investors, whether they turn to a broker-dealer or an investment adviser for assistance in accessing the securities markets.

Finally, hedge funds and other unregulated private pools of capital have flown under the radar for far too long. We are currently examining whether these funds, their managers or both should be subject to SEC registration and oversight, so that investors, regulators and the marketplace have more complete and meaningful information about the funds and their market activities. I look forward to working with Congress on this important issue.

### **Strengthening Shareholder Rights**

We have launched an agenda of proxy reforms with a proposal approved by the Commission for public comment that would significantly support shareholders' rights to nominate company directors. Next month we will take up a broad package of corporate disclosure improvements, all designed to provide shareholders with important information about their company's key policies, procedures and practices, including compensation policies and incentive arrangements. With this additional information, shareholders will be better able to hold directors accountable for the decisions that they make. For example, the Commission will consider proposals to enhance disclosure of director nominee experience, qualifications and skills, so that shareholders can make more informed voting decisions. The Commission will also consider proposed disclosures to shareholders about why a board has chosen its particular leadership structure (whether that structure includes an independent chair or combines the positions of CEO and chair), so that shareholders can better evaluate board performance. Also, shareholders should understand how compensation structures and practices drive an executive's risk-taking. The Commission will be considering whether greater disclosure is needed about how a company – and the company's board in particular – manages risks, both generally and in the context of compensation. The Commission will also consider whether greater disclosure is needed about a company's overall compensation approach, beyond decisions with respect only to the highest paid officers, as well as about compensation consultant conflicts of interests.

### **Improving Money Market & Mutual Fund Regulation**

Later this month, the SEC will consider proposals to strengthen the money market fund regulatory regime. The proposals will focus on tightening the credit quality, maturity and liquidity standards for money market funds to better protect investors and make money market funds more resilient to risks in the short-term securities markets, like those that unfolded last fall. In addition, we are exploring whether more fundamental changes are necessary, such as converting money market funds to a floating rate net asset value, in order to protect investors from abuses and runs on the funds.

In addition, on June 18, the SEC and the Department of Labor will hold a joint hearing on target date funds. Target date funds and other similar investment options are investment products that allocate their investments among various asset classes and automatically shift that allocation to more conservative investments as a "target" date approaches. These funds have become quite

popular, and growth in target date fund assets is likely to continue since these funds can be default investments in 401(k) retirement plans under the Pension Protection Act of 2006. However, target date funds have produced some troubling investment results. The average loss in 2008 among 31 funds with a 2010 retirement date was almost 25 percent. In addition, varying strategies among these funds produced widely varying results. Returns of 2010 target date funds ranged from minus 3.6 percent to minus 41 percent.

These returns cause concern for investors and regulators alike. I can assure you that SEC staff is closely reviewing target date funds' disclosure about their asset allocations. In addition, in connection with our joint hearing with the Department of Labor, we will consider whether additional measures are needed to better align target date funds' asset allocations with investor expectations. Among other issues, we will consider whether the use of a particular target date in a fund's name may be misleading or confusing to investors and whether there are additional controls the SEC should impose to govern the use of a target date in a fund's name.

I also have asked the staff to prepare a recommendation on rule 12b-1, which permits mutual funds to use fund assets to compensate broker-dealers and other intermediaries for distribution and servicing expenses. These fees, with their bureaucratic sounding name and sometimes unclear purpose, are not well understood by investors. Yet in 2008, rule 12b-1 was used to collect over \$13 billion in investors' funds out of fund assets. It is essential, therefore, that the SEC engage in a comprehensive re-examination of rule 12b-1 and the fees collected pursuant to the rule. If issues relating to these fees undermine investor interests, then we at the SEC have an obligation to step in and adjust our regulations.

In addition to these initiatives, the agency continues to annually review 5,000 corporate filings, over 1,000 SRO rules, and nearly 3,000 new investment company portfolio disclosures. We establish the standards for 13 securities exchanges, 4 securities futures product exchanges, FINRA (a national securities association), the Municipal Securities Rulemaking Board, 10 nationally recognized statistical rating organizations, 10 registered clearing agencies, approximately 600 transfer agents, and securities information processors. Despite the extreme volatility and uncertainty in the markets over the past year, transactions continue to trade at both record volumes and record speed.

## **SEC Resources**

The financial crisis has reminded us just how large, complex, and critical to our economy the securities markets have become in recent years. Whereas the dollar value of the average daily trading volume in stocks, exchange-traded options and security futures was \$10 billion a day in February 1989, over the last 20 years it has grown to over 25 times that size, reaching approximately \$251 billion a day in February 2009. And not only has the size of our markets exploded, the number and size of its participants have jumped as well. For example, since 2005, the number of registered investment advisers has increased by 32 percent, and their assets under management have jumped by over 70 percent to reach more than \$40 trillion as of the beginning of this fiscal year. Broker-dealer operations have expanded significantly in size, complexity, and geographical diversity, as exemplified by the 67 percent rise in the number of broker-dealer branch offices. In all, the SEC's 3,652 staff now oversee more than 35,000 registrants, including

about 12,000 public companies, 8,000 mutual funds, 11,300 investment advisers, 5,500 broker dealers, and 600 transfer agents. By comparison, other financial regulators often have close to parity between the number of staff and the number of entities they regulate. For additional detail, attached to this testimony is an appendix, "SEC Staff Levels Have Not Kept Pace with Industry Growth."

Yet at the same time that the securities markets have undergone such tremendous growth, the SEC's resources have fallen further and further behind. Between FY 2005 and FY 2007, the agency experienced three years of flat or declining budgets, losing 10 percent of its employees and severely hampering key areas like our enforcement and examination programs. In the context of rapidly expanding markets, I believe these reductions in the SEC's staff seriously limited the agency's ability to effectively oversee the markets and pursue violations of the securities laws.

With support from this subcommittee, during the last two fiscal years, the SEC has been able to lift its hiring freeze and begin rebuilding its workforce. By increasing the SEC's appropriation for this fiscal year, approving a reprogramming of additional resources, and just recently supporting emergency supplemental funds for the agency, this subcommittee has expressed its strong support for the SEC and its mission. I am very grateful for that support.

However, even with these important steps, the number of staff with which the SEC can detect fraud, prosecute wrongdoing, ensure proper disclosure, conduct strong oversight of the markets, and take other actions to protect investors, is still significantly below the levels of only a few years ago. Under the SEC's current funding level, the agency's workforce still will fall about 200 staff, or about 5 percent, short of the FY 2005 level.

I believe additional resources are essential if we hope to restore the SEC as a vigorous and effective regulator of our financial markets. The President is requesting a total of \$1.026 billion for the agency in FY 2010, a 7 percent increase over the FY 2009 funding level. This proposal would permit the SEC to fully fund an additional 50 staff positions over 2008 levels, enhance our ability to uncover and prosecute fraud, and begin to build desperately needed technology.

Specifically, these positions would help the SEC's Enforcement program enhance its pursuit of tips, complaints and other leads, thus increasing the resources the SEC can dedicate to frauds that citizens bring to our attention. They would also allow us to hire more trial lawyers and staff with specialized skills that will help our Enforcement program's efficiency, expertise and success. The Examination program would hire market experts to strengthen risk-based oversight of the investment management industry and expand its inspections of credit rating agencies. Our Division of Trading and Markets would strengthen its oversight of entities that play critical roles in our markets, such as broker-dealers, exchanges, clearing corporations, and other self-regulatory organizations. And the President's Budget would allow us to expand our Office of Risk Assessment by fully funding our program to bring in seasoned industry professionals to help uncover hidden risks to investors.

Although expanding our workforce is a critically important step, I believe we also must give our staff better tools to conduct oversight of vast financial markets. That is why the President's request for FY 2010 also contains funds for additional investments in our information systems. Investments in new systems have dropped by more than half over the last four years, and as a result the SEC has a growing list of technology needs that have gone unfunded. With the additional IT funds provided under the President's Budget for FY 2010, I would plan to focus on several key projects:

First and foremost, we would use additional funds to enhance our systems for handling tips, complaints and referrals. Although the SEC has a number of different processes to track this kind of information, there is no central repository or system through which this information comes together to ensure it is handled consistently or appropriately. Nor is there any present capability to mine the data to find connections, patterns or trends that would enable us to more intelligently focus our enforcement efforts.

The SEC also plans to improve our ability to identify emerging risks to investors. We have many internal data repositories from filings, examinations, investigations, economic research and other ongoing activities. But the SEC needs better tools to mine this data, link it together, and combine it with data sources from outside the Commission to determine which firms or practices raise red flags and deserve a closer look.

Finally, we would invest in our multi-year efforts to improve the case and exam management tools available to our enforcement and examination programs. These systems would give our senior managers better information on the mix of cases, investigations, and examinations, so they can apply resources swiftly to the continually evolving set of issues and problems in the markets. In addition, these tools will provide better support for line staff in these programs, so they can be more productive and better able to match the sophisticated systems used by the financial industry.

I came to the SEC to shape public policy in the interest of investors and to strengthen our enforcement program. The things I have described in this testimony are important to those efforts. But what I have also discovered in the past four months is that much attention needs to be focused on the internal operations of the agency, the processes that guide our work, the agency's infrastructure and how we are organized. I have been disappointed to find that in some areas of our internal operations, we fall short of what the taxpayer has a right to expect of us, and what our employees have a right to expect of a world class organization. I am committed to a complete review of areas large and small, including FOIA operations, call centers operations, records management, and others, to ensure that we meet the highest standards and that we are fully supporting the important work of our employees in these operations. Doing this will take time and energy and focus. To ensure that we do it well and thoroughly, I intend to bring in a Chief Operating Officer to manage the process. Federal agencies do not manage themselves; we must be actively engaged in that process everyday.

In one area, we have already made progress: we are moving to build an internal compliance program that is second to none. The public appropriately holds the SEC to a very high standard

for integrity and professionalism, and we hold ourselves to that very high standard as well. That is why I have initiated several steps to guard against inappropriate securities trading by SEC staff, as well as to avoid any appearance of inappropriate trading. Among other steps, the agency has drafted new internal rules that would prohibit staff from trading in the securities of companies under SEC investigation, regardless of whether an employee has personal knowledge of the investigation, and require preclearance of all trades. The SEC also is contracting with an outside firm to develop a computer compliance system to track, audit and oversee employee trades and financial disclosures in real time. Finally, I consolidated responsibility for this area within our Ethics Office and authorized the hiring of a new chief compliance officer. To further enhance the SEC's financial controls, the agency also will continue its multi-year efforts to build an automated, integrated financial management system.

I want to thank you for your continued strong support for the SEC and its critical mission. I believe the steps I have outlined here — strengthening our enforcement program, enhancing risk-based oversight of the markets and leveraging technology — are essential for restoring investors' confidence in both the SEC and in our nation's securities markets.

I would be happy to answer any questions you may have.

---

<sup>1</sup> SEC v. Reserve Management Company, Inc., et al., *Lit. Rel. No. 21025* (May 5, 2009).

<sup>2</sup> SEC v. Henry Morris, et al., *Lit. Rel. No. 20963* (March 19, 2009), *Lit. Rel. No. 21001* (April 15, 2009), *Lit. Rel. No. 21018* (April 30, 2009); *Lit. Rel. No. 21036* (May 12, 2009).